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SUBJECT: ECONOMY TOXIC FOR SOUTH CHINA'S CHEMICAL INDUSTRY

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¶1. (U) SUMMARY: It doesn't matter too much where you fall in the supply chain - upstream manufacturers in the Pearl River Delta (PRD) are suffering the same impact from the global economic downturn as their downstream customers. The chemical industry in South China has been hit hard with orders from the U.S. and Europe falling sharply during the fall of 2008. Domestic demand, however, has remained relatively steady, leading many export-oriented firms to shift focus to the local market. Many firms have seen possible signs of recovery in recent months, and their optimism about the future may bode well for the PRD's manufacturing industry as a whole. END SUMMARY.

#### Bulging Warehouses

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¶2. (SBU) The warehouse at the Sartomer Chemical plant in Nansha clearly shows effects of the economic downturn. The massive space, roughly the size of two airplane hangars is stocked floor to ceiling with drums of chemical resins ready for shipment to customers in the United States. Those orders, however, have long since been cancelled. Sartomer saw a dramatic drop in U.S. orders beginning in November of last year and leading to a 1,000 ton surplus. "We never thought that we'd fill it," Sartomer Chemicals Operations Director Phil Jackson said of the warehouse. Sartomer manufactures polymers and oligomers for use in inks, paints, CDs, and many construction related applications. The company's largest customers are construction material producers and printing shops. U.S. demand was propped up through November by the printing industries need for inks to make campaign signs, according to Jackson, but fell abruptly during the final weeks of 2008. In China, the company depends heavily on the construction industry. While sales within China are still robust, the company is waiting for an indication that international demand will pick back up.

¶3. (SBU) Sartomer's experience is consistent with what other chemical makers in the PRD have told us. The South China's chemical industry was hit hard by the economic downturn. Many factories showed record sales during 2008, but demand collapsed during the fall as orders from overseas customers plummeted. Domestic demand has remained relatively strong, insulating companies that produce primarily for the domestic Chinese market. But companies dependent on demand from the U.S. and Europe have been severely affected, many enduring the worst stretch in their respective histories.

¶4. (SBU) The chemical industry's exhibition hall at this year's

Canton fair was lined with about the same number of booths as in years past. Chemical company representatives passed out glossy brochures to anyone who happened by, but companies expressed frustration over the lack of customers. Stephen Zhao of Sundia Chemical Industry Limited complained that attendance at the fair was significantly down, and a nearby vendor worried that as of 4:00 pm on the opening day he had yet to make a single sale.

#### Eyeing the Local Market

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15. (SBU) Several export-oriented companies have reported re-thinking their business strategy and adopting a new focus on domestic demand in response to the crisis. Last year, both Sartomer and Sabic were selling over 70% of their output overseas. This year, Sartomer predicts that it will sell over 90% of its total production on the Chinese market. Sartomer has seen its largest sales growth in the domestic construction supplies industry, which according to Jackson has continued to increase orders despite the downturn. Sabic's Maggie Wang said that her company hoped Chinese sales will soon account for 75% of its total business. Sabic is a high-end manufacturer whose plastics are used in a wide range of products including electronics, automobiles, medical supplies, and sporting goods. Their major customers include Microsoft, Canon, Nokia, Dell, GM and Toyota, but their new focus on the domestic market has led them to increase sales to customers within China including rechargeable battery producer BYD, Huawei and Lenovo. Wang predicted that the firm's sales to Chinese customers would remain strong in part due to growing demand within China for small laptops, which require high-end plastics.

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#### Signs of Recovery?

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16. (SBU) While international orders for the PRD's chemical makers remain well below the levels they reached in mid 2008, some companies have reported signs of recovery. Many have seen orders begin to increase slowly in the first few months of 2009 and a few have already returned to their pre-downturn sales levels. According to Maggie Wang, Microsoft, which uses plastics produced in South China in many of its consumer electronics, has predicted that by mid 2009 their orders for Sabic's plastics will return to their pre-downturn levels. Many chemical manufacturers still express a great deal of confidence in the industry's future in South China. Exhibitors at the Canton Fair expressed optimism despite disappointing sales at the trade event. Some firms have continued to show some growth even during the economic crisis. Firms such as Sabic, LG, and Guangdong Chemical have all moved forward with large expansion projects in the region despite lagging sales.

17. (SBU) Anticipating a recovery in orders, some companies are also bracing themselves for a lack of raw materials. Sabic CEO Mohamed 18. Al-Mady has warned that the company may face a serious shortage during the second half of this year. The downturn has caused a major shakeup in the market for the industry's raw materials. Ketty Zhu of Guangzhou Ganglian Chemical, a producer of chemicals for use in health and beauty products, says that many low-end producers were driven out of business in recent months. Zhu worries that if demand picks up again, competition for raw materials may push prices to much higher levels.

#### Frustrated by Regulatory Environment

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18. (SBU) Even as they remain focused on the challenges posed by the economic downturn, foreign-owned chemical companies in Guangdong express frustration with the province's complex and non-transparent regulatory environment. Phil Jackson of Sartomer recently learned firsthand how difficult working with the Chinese government can be. The company's new plant opened last spring, but only after years of struggling to obtain all the proper permits. Jackson expressed frustration at the overly complex process that included many different rounds of inspection and lacked transparency. Among the requirements that delayed the issuance of the permits were the

installation of a complex fire-fighting system, the requirement for a greater distance between buildings than would have been called for in the U.S. or Europe, and a \$20,000 piece of equipment to clean the emissions from the plant's cafeteria. Several companies complained that regulations often change so fast that they are unable to keep up with them, a criticism we heard frequently from U.S. firms across a broad range of industries.

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